

Exhibit 2 to the Xu Declaration



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Venezuela this Week: September 12-18, 2016

Dispatch from Caracas

Our key takeaway after a week in Caracas is that stabilization is closer than it appears. Large cuts in real public expenditures have significantly reduced fiscal imbalances and limited the need for monetizing the deficit. The country has avoided hyperinflation at the cost of a deep recession. The stabilization appears to be helping the government's approval numbers, but probably not enough to enable it to beat back the referendum drive.

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What to watch this week

- The National Electoral Council (CNE) will **announce the total number of centers and fingerprint machines** for the collection of the 20% of signatures needed to validate the recall referendum on the week of October 24. The opposition may boycott the event if it deems that the number of fingerprint machines is too low or if the CNE requires that a threshold of 20% is met in every state and not just nationally.
- **OPEC will release August production data** in its Oil Market Report today. The government has already stated that August saw a production decline to 2,328 tbd from 2,447 tbd in August, so the new information will come from secondary source data. In the secondary source data, July had seen a decline of 19 tbd, contrasting with the official data. Baker-Hughes data show a recovery to 53 from 50 total rigs in the month of August.
- UNASUR continues to advance **efforts to kick-start government-opposition talks**. Mission Chief José Luis Rodríguez Zapatero met with President Maduro for 45 minutes on Sunday, and authorities freed the Spanish-Venezuelan activist Gabriel San Miguel on Friday. Local press has reported that a draft agreement may include the release of opposition leaders Manuel Rosales and Leopoldo López.
- The conflict between the legislative and the executive and judiciary branches continues to escalate as the **National Assembly refused to back down** from the swearing-in of three Amazonas deputies who had been suspended by the Electoral Court. According to *El Nacional*, the National Treasury Office did not transfer the resources necessary to pay legislators' wages corresponding to the last two weeks of August.
- The **Summit of Non-Aligned Countries will take place in Margarita Island** between September 13 and 18. The government has tightened security in the area, which will receive ten thousand delegates including several heads of state of the movement's 120 member countries.
- The opposition has called for **new protests on Wednesday September 14** to protest the lack of CNE announcements. Protests last week counted with low turnout, in contrast to the large September 1 demonstrations.
- PDVSA may finally announce details of its **offer to swap up to \$7bn of upcoming maturities** on the 2017 8 ½ and 5 ¼ bonds. Failure to present the offer within the next two weeks would make it very difficult to comply with the regulatory requirements of an offer in the United States.

Dispatch from Caracas

First impressions

Last week we led our first Torino research trip to Caracas accompanied by a small group of clients. During these days, we had the opportunity to meet with cabinet members and other high-ranking government officials as well as electoral authorities, opposition and government political leaders, private sector representatives and economic and political analysts. The trip helped bring into focus a clearer view of the interaction between the country's economic and political processes which contrasts strongly with the conventional wisdom.

Venezuela is commonly seen as an economy that is in the midst of developing a full-fledged hyperinflation as spending far outstrips revenues and a large deficit is continuously monetized. While that was probably a correct view up to 2015, we see a different story developing this year. We believe the economy has undergone a drastic fiscal and external adjustment in the first eight months of 2016, reducing the deficit and limiting the needs for money creation. What had up to now been primarily a quantity adjustment is now becoming much more of a price adjustment. In this sense, the spike in inflation observed earlier this year reflects a loosening of price controls and materialization of one-time price adjustments rather than a process of runaway money creation. This means that price inflation could well be beginning to stabilize and that, at the very least, the economy is unlikely to veer off into hyperinflation any time soon.

Whether this is good news for the government is unclear. If what the government did was to avoid further inflationary acceleration through deep fiscal cuts, then it effectively traded off hyperinflation for contraction. Whether one of these is better than the other politically is disputable; yet it is clear that a turnaround in public opinion is unlikely without a major economic recovery. Even if the government staved off a hyperinflation, the fact that it did so through deep real spending and import cuts suggests that the political payoff to its strategy will be limited at best. While the government may do better in a recall referendum than it would under a full-fledged hyperinflation, that still does not mean it would win it.

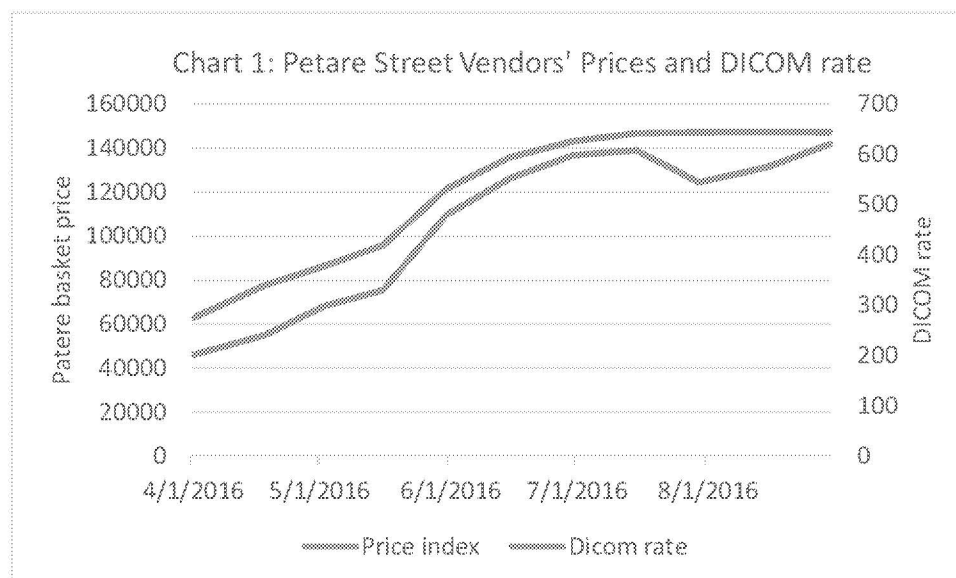
Adjustment in plain sight

Our discussions with government officials in charge of economic policy confirmed our view that spending growth has fallen well below that of revenue so far this year. As we argued in the August 29 edition of this report, authorized central government nominal spending has grown just 103% year-on-year so far in 2016, far below just about any estimate of inflation, as well as significantly below increases in nominal tax collection and non-tax revenues.¹ The consequent reduction in the real fiscal deficit has limited the need for money creation. Monetary base growth now stands at 121% year-on-year while central bank lending to state-owned enterprises (the main source of deficit monetization) has grown at just 97% year-on-year. In a setting where

¹ "Venezuela this Week, August 29-September 4: To Hike and to March."

inflation estimates range anywhere from 200 to 800%, this represents a significant reduction in real monetary financing of the government deficit.

Authorities did recognize that inflation had been high, particularly in the months of May and June, but also said that prices had started to stabilize in recent months. This is consistent with at least some private sector data. For example, the private consultancy Hinterlaces' measure of street vendor prices in the Petare sector of Caracas grew by 202% between April 1 and July 15 (a monthly rate of 37.1%) yet by just 2.0% between July 15 and August 30 (a monthly rate of 1.4%). This rate of increase appears to closely track that of the Dicom rate (Chart 1), the only rate at which private sector importers are currently receiving dollars (the preferential Dipro rate is by and large restricted to public sector imports).



Source: Torino Capital, Hinterlaces, Bloomberg.

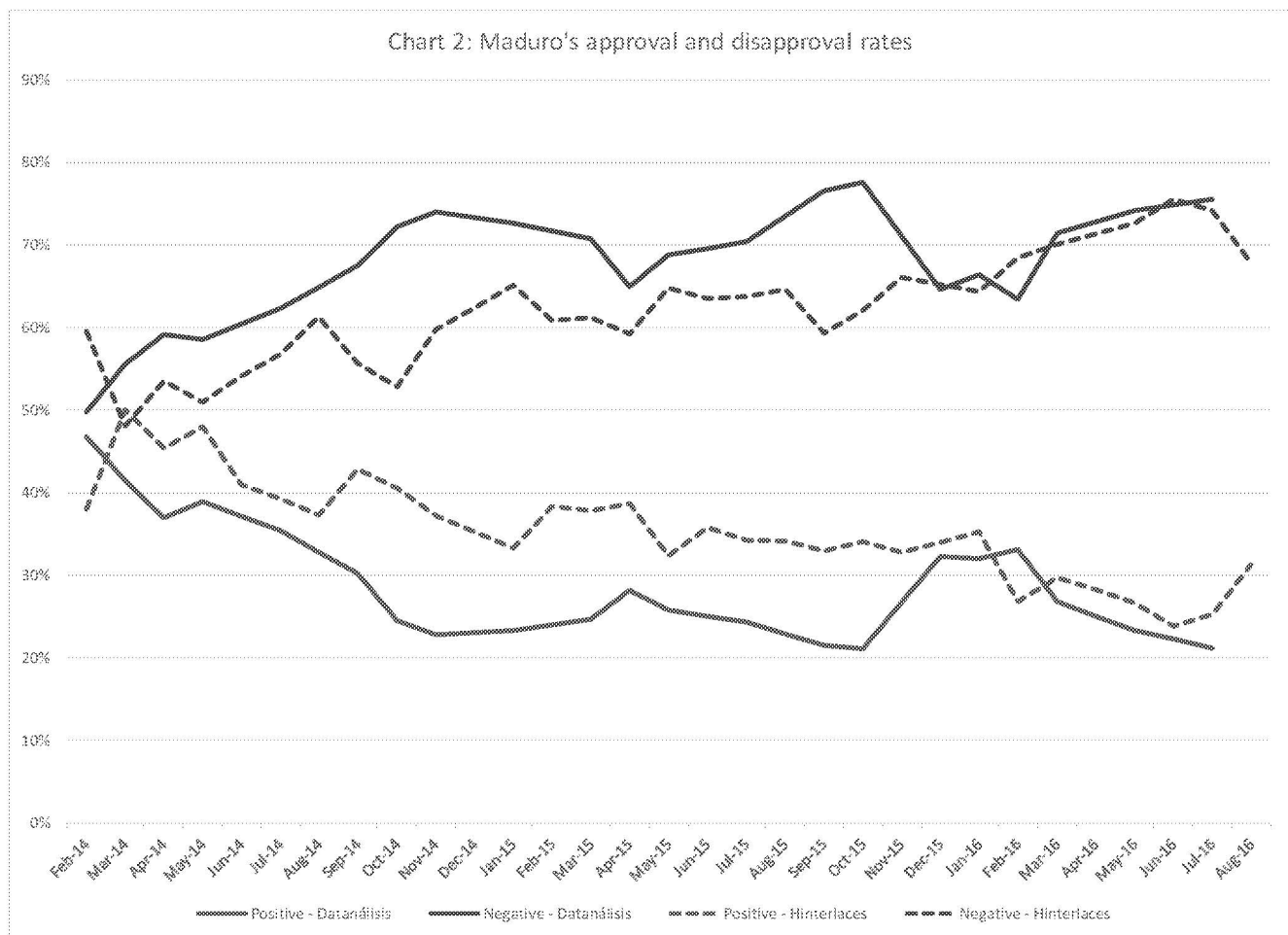
Note: Petare basket expressed in VEF, while the DICOM rate is in VEF/USD.

The data thus suggests that the economy carried out significant price increases during the first half of the year, as prices began to track the Dicom rate. The spread between Dicom and the parallel rate is now well in line with the historical post-devaluation spreads between the official and market rate. In other words, Venezuela appears to have carried out a major devaluation of the exchange rate relevant for private sector price-setting this year, allowing what had up to now been a quantity adjustment to transition to a price adjustment.

Our analysis was complemented by a visit to the Petare Roundabout, where informal vendors displayed ample supplies of food products and other basic staples, all sold at unregulated prices. These observations were consistent with our view of Venezuela as an economy where scarcity has until now been driven primarily by price controls, and where the easing of these price controls over the past eight months has allowed markets to begin to clear and the needed real depreciation to materialize and affect private sector behavior.

The referendum and other questions

The latest survey results are starting to give some indication that the recent stabilization of prices may have given the government a much-needed boost in its poll numbers². The August Hinterlaces survey showed Maduro's approval rating recovering to 31.3% in August from 25.3% in July and a low of 22.0% in June. As Chart 2 shows, Datanálisis and Hinterlaces have historically presented similar trends for presidential approval ratings; since the latest Datanálisis poll is from July, we will have to wait for their September poll (currently being conducted) to confirm the improvement in Maduro's approval in their series.



Source:Torino Capital, Datanálisis, Hinterlaces.

Note: Series represent percentage of respondents.

Would this be enough to stave off defeat in a potential recall referendum? That seems unlikely. Only 27.8% of Venezuelans would vote in favor of Maduro in the recall vote, less than half the 61.8% that would vote

² The Hinterlaces poll was carried out during the week of August 1-6 and had a sample size of 418 interviews covering 22 states and with a margin of error of 5.0%. The Datanálisis poll was carried out between July 13 and July 21 on a sample of 1000 interviews and had a margin of error of 3.0%.



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against, according to the August Hinterlaces poll. While this represents an improvement from mid-June, when he was losing the recall vote 19.8-70.1%, it is still much less than what would be needed to turn the tables electorally.

That said, there are still many hurdles that have to be cleared for the opposition for an effective recall. After our discussions with electoral authorities and political leaders from both sides of the spectrum, we see a reasonable probability that the CNE will decide this week to request that the opposition meet the 20% threshold of registered voters in every single state, as opposed to just nationally. Authorities also seem to be inclined to use around 3900 fingerprint machines during the validation procedure, well below the 40 thousand requested by the opposition.

The legal and constitutional basis for these decisions is disputed by the opposition. Both are likely to represent major hurdles for the collection process. For example, in the June validation of the 1% required signatures, the opposition was able to validate 1,331 signatures per fingerprint machine during five days. In this event, it would have to validate 1,000 signatures per machine in just three days. There is thus an important risk that the opposition will decline to participate in the signature collection process under these conditions, opening up a set of uncertain political scenarios.

Of debts and swaps

There has been little to no public communication of PDVSA regarding its intention to present an offer to bondholders to swap out of the upcoming 2017 amortizations. Our conversations in Caracas confirmed that delays had been due to the difficulties obtaining a paying agent for the transaction, an impediment that appears to have been resolved. Therefore, we do expect a public swap announcement to be made during the next two weeks. If the offer does include a new CITGO-guaranteed issuance, we see reasonable incentives for bondholders to participate.

Authorities continued to reaffirm their commitment to honoring the country's external debt, and we see few indications that this commitment has changed. They noted that their strategy is to seek to change the debt profile through voluntary swaps of both the PDVSA and the sovereign. FX flows have improved somewhat in recent months due to higher oil prices and the materialization of a 2-year extension on China loan amortizations that we estimate is generating FX savings of approximately \$450mn a month. In fact, authorities were confident that the supply situation would improve as goods paid for with these additional flows started to come into the country in the next few months. Oil production, however, continues to be the Achilles' heel of the Venezuelan economy, as it is unclear that a continuation of the slide in production can be averted despite the recovery of oil prices from their 1Q15 levels.

We found our conversations with opposition politicians comforting, as there was little support for a forced restructuring of external debt if the opposition came to power. Differences between opposition leaders are much more centered on strategic issues regarding how to bring about regime change than regarding their vision of how to run the economy once they come to power. Almost all of them share the view that policies should be much more market and investor-friendly and seem keen to avoid proposals, such as that of debt



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restructuring, that would increase market uncertainty. Rejection for the idea of a PDVSA bankruptcy (which would be necessary to shield assets from attachment in the US during restructuring negotiations) is almost unanimous. Opposition representatives also reassured us that they would not question the legality of the PDVSA bond swap, as they agreed with the interpretation of the law according to which a new PDVSA issuance (even if it was backed by CITGO) does not require National Assembly authorization.

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